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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, AUGUST 6, 1998

APPLICATION OF

ROANOKE GAS COMPANY

CASE NO. PUE960102

For an Annual Informational Filing

and

APPLICATION OF

ROANOKE GAS COMPANY

CASE NO. PUE960304

For expedited rate relief

FINAL ORDER

On July 9, 1996, Roanoke Gas Company ("Roanoke" or "the Company") completed the filing of its Annual Informational Filing ("AIF") with the State Corporation Commission ("Commission"). Roanoke's AIF was supported by financial and operating data for the twelve months ended March 31, 1996.

On October 25, 1996, after analyzing the Company's data, the Staff filed its report, finding that Roanoke earned above its authorized return on equity range of 11.2% to 12.2%. The Staff concluded that the Company's earnings were sufficient to recover the unamortized balances of rate case expenses, depreciation study costs, franchise costs, liquified natural gas

("LNG") tank painting costs, union contract negotiation costs, union organization costs, and early retirement costs associated with personnel. The Staff recommended that these costs be excluded from Roanoke's future AIFs and rate cases.

On November 15, 1996, the Company filed its response to the Staff's report, objecting to the Staff's use of an earnings test. It also challenged Staff's use of an actual rather than weather normalized calculation of revenues in Staff's earnings test analysis.

On December 2, 1996, Roanoke filed an application with the Commission for expedited rate relief, wherein it proposed to increase its gross annual operating revenues by \$959,277.¹ The Company supported its rate request with financial and operating data for the twelve months ended September 30, 1996. In its December 10, 1996 Order, the Commission consolidated the Company's rate application with Roanoke's AIF.

On December 20, 1996, the Commission entered an Order permitting the Company to implement its proposed tariff revisions and rate increase on an interim basis, subject to refund with interest, for service rendered on and after January 1, 1997. By Order dated January 21, 1997, the Commission assigned a Hearing Examiner to the matter,

¹ During the hearing, the Company reduced its requested increase in revenues to \$602,499.

established a procedural schedule, and set the application for hearing on June 25, 1997.

The matter was timely heard, and the Staff and Company filed simultaneous briefs on August 8, 1997.

The Chief Hearing Examiner issued her report in this matter on April 30, 1998. Based upon the evidence received, the Examiner found that:

1. The use of a test year ending September 30, 1996, is proper in this proceeding;
2. The Company's test year operating revenues, after all adjustments, were \$48,263,533;
3. The Company's test year operating expenses, after all adjustments, were \$44,749,080;
4. The Company's test year operating income and adjusted operating income, after all adjustments, were \$3,514,452 and \$3,474,794, respectively;
5. The Company's adjusted test period rate base, updated to March 31, 1997, is \$37,683,313;
6. The Company's current rates produced a return on adjusted rate base of 9.221% and a return on equity of 10.150%;
7. The Company's cost of equity is within a range of 10.70% to 11.70%, and rates should be established at the midpoint of that range, 11.20%, and should provide a return on rate base of 9.663%;
8. The Company's current rates are unjust and unreasonable because they will

generate a return on rate base of only 9.221%;

9. The Company's requested increase in rates is not just and reasonable based on the reasons identified in the report;

10. The Company requires an increase in gross annual revenues of \$260,432 to earn a 9.663% return on rate base;

11. The Company should file permanent rates designed to produce the additional revenues found reasonable herein effective January 1, 1997, to be consistent with Staff's revenue apportionment. The final increase in revenues should be distributed on an equal percentage basis to each volumetric rate block within the rate schedule;

12. The Company should be required to refund, with interest, all revenues collected under interim rates in excess of the amount found just and reasonable herein;

13. The Company should credit the expense accounts originally charged when billing affiliated companies for management services, accounting and billing, rather than recording management fees as revenues; and

14. As recommended by Staff, the Company should capitalize several items, totaling \$75,527, which had been expensed by the Company. The Company should book a credit to the appropriate operations and maintenance expense accounts in the current period with a debit to the appropriate asset accounts as agreed to by Company witness Williamson.

The Chief Hearing Examiner recommended that the Commission enter an order adopting the findings in her report, increasing

the Company's authorized gross annual revenues by \$260,432, and directing the refund with interest of all amounts collected under the interim rates in excess of the rate level found just and reasonable in her report.

Comments on the Hearing Examiner's Report were filed by the Company and Staff. Roanoke filed Comments wherein it further reduced its proposed increase in revenues from \$602,499 to \$454,307. Among other things, it objected that an earnings test constituted retroactive ratemaking. Alternatively, the Company maintained that if an earnings test was applied, the test should be fully adjusted to include the effects of weather normalization, and the write-off of regulatory assets should be made only with earnings exceeding the top of Roanoke's return on equity range rather than being written off to the bottom of that range. The Company further complained that Staff applied costs in the earnings test twice to the same earnings, and urged the Commission to adopt the other recommendations in the Hearing Examiner's report.

The Commission Staff filed Comments, taking exception only with the Chief Hearing Examiner's recommendation that in applying an earnings test, Roanoke's existing regulatory assets should be deemed recovered to the extent its earnings exceed the top of the Company's authorized return on equity range. Staff supported the use of the bottom of a utility's authorized return

on equity range as the appropriate benchmark in an earnings test to evaluate whether regulatory assets - new or existing - have been recovered. The Staff requested the Commission to clarify the Chief Hearing Examiner's description of the appropriate accounting adjustments for an earnings test, and urged the Commission to adopt her other recommendations.

On June 25, 1998, Columbia Gas of Virginia, Inc. ("Columbia") filed its Brief Amicus Curiae.² In its Brief, Columbia asserts that Exhibit SCA-15, a letter to all utilities from Ronald A. Gibson, Director of the Division of Public Utility Accounting, constituted an unlawful rulemaking which propounded new rules on how rate cases should be prepared and filed.³ Columbia further maintains that the Staff's application of an earnings test unreasonably and unfairly excludes a weather normalization adjustment. It contends that Roanoke's previously approved regulatory assets should not be written off to the bottom of the utility's return on equity range. On July 6, 1998, the Staff filed its reply thereto.

Having considered the record, the Chief Hearing Examiner's Report, the Comments thereon, Columbia's Brief, and the reply thereto, the Commission is of the opinion and finds that the

² In an Order dated June 23, 1998, among other things, the Commission granted leave to Columbia to file a brief in the nature of a brief amicus curiae (hereafter "Columbia's Brief").

³ References to Exhibits shall be cited herein as "Ex. ____".

findings and recommendations of the Chief Hearing Examiner should be adopted, with the exception of her recommendation that a distinction should be drawn between previously approved regulatory assets and those that are newly created when applying an earnings test. The Examiner recommended that previously approved regulatory assets should be regarded as recovered only with earnings above the top of a utility's authorized return on equity range, while newly created regulatory assets should be written off to the bottom of Roanoke's authorized return on equity range. We decline to adopt the Hearing Examiner's recommendations on these issues for the reasons set out below. Rather, we find that the bottom of Roanoke's authorized return on equity range should be used to evaluate recovery of all regulatory assets.

We turn now to the arguments that: (i) the earnings test should be considered retroactive ratemaking; (ii) the earnings test results should be weather normalized; (iii) the Staff's position letter constitutes illegal rulemaking; (iv) the earnings test has been applied twice to the same earnings; and (v) the top rather than the bottom of the authorized return on equity range should be used as the standard to evaluate whether regulatory assets should be deemed recovered. We will address these arguments seriatim.

Based on the record made herein, we do not find the application of an earnings test to Roanoke's test year earnings to constitute retroactive ratemaking. An earnings test is applied to earnings results within a test period. No refund of revenues previously collected occurs as a result of the application of an earnings test. Rather, the purpose of the earnings test is to evaluate whether regulatory assets on the utility's books during the test period have been recovered more quickly than anticipated or whether they should continue to be deferred and amortized. We affirm the Hearing Examiner's findings on this issue.

Columbia has asserted that the Staff's letter describing its proposed use of an earnings test (Ex. SCA-15) constitutes an illegal rulemaking. This assertion is erroneous. The views stated in Ex. SCA-15 are Staff's and the exhibit's express purpose is to provide guidance to utilities on how the Staff proposes to treat regulatory assets. In our view, the Staff may advocate the application of earnings tests to companies like Roanoke that have regulatory assets on their books. Such activity by the Staff does not constitute rulemaking, but merely the development of additional information about regulatory assets that we may consider. The ultimate disposition of these and other items remains with the Commission.

The Company has also asserted that the results of an earnings test should be weather normalized. As noted earlier, the purpose of an earnings test is to review test period results to determine whether deferred costs were actually recovered more quickly than anticipated. Accordingly, the per books results of the earnings test should not be weather normalized. Instead an earnings test employs per books data for a test period, based on average rate base and investment. Typical adjustments used in an earnings test are those necessary to restate per books results to a regulatory basis, such as adjustments to correct booking errors and inclusion of JDC capital expense and associated tax savings. Removal of out-of-period expense items are made only in limited circumstances and include adjustments necessary to true up a gas utility's purchased gas adjustment or to reverse the effect of an out-of-period base rate refund. Therefore, we agree with the Chief Hearing Examiner that no adjustment for weather should be made to per books results for an earnings test.

Roanoke has argued that the earnings test is being applied unfairly because the test has been applied twice using the same earnings. We disagree and affirm the Examiner's findings on this issue. The test periods for Roanoke's AIF and rate case overlap by six months in this case. The test period for the AIF was the twelve months ending March 31, 1996, while the test

period for the expedited rate application was the twelve months ending September 30, 1996. The costs for the deferrals at issue have been applied ratably in this case with one half of the total regulatory assets costs being attributable to the AIF test period ending March 31, 1996, and the other half being applied to the rate case using a test period ending September 30, 1996. Thus, no double counting of these costs has occurred in this case.

The next issue we must address is whether, in applying the earnings test to previously approved deferred expenses, the benchmark is the top or bottom of the range or a point within the range. This question flows from the Appalachian Power case we decided in 1996.⁴ In that case we held that in establishing the amount of a deferrable expense for ratemaking, we would apply an earnings test such that the expense was deemed recovered to the extent it could be expensed and the company's return on equity was equal to or greater than the bottom of the allowed range of return on equity.

While Roanoke and Columbia disagree with any application of an earnings test in this case, they assert that, if the test is applied, previously existing regulatory assets should be written off only to the top of the Company's authorized return on equity

⁴ Application of Appalachian Power Co., For an expedited increase in base rates, Case No. PUE940063, 1996 S.C.C. Ann. Rept. 255 (hereafter "the APCO Case").

range. We disagree. Further, as noted in the Staff's reply, the costs associated with the demolition of the retired gas manufacturing plant, the "regulatory asset" that the Examiner, Roanoke and Columbia characterize as previously existing, have not been previously approved for deferral by the Commission. The deferred costs associated with the demolition of the retired gas manufacturing plant were not incurred until after Roanoke's AIF test period, i.e., the twelve months ending March 31, 1996. Ex. SCA-12 at 23-24. Roanoke's costs from the demolition of the retired gas manufacturing plant thus are a newly created regulatory asset, and like the costs for storm damage in the APCO Case, should be written off to the bottom of the range.

In addition, we decline to adopt the Hearing Examiner's "newly created/previously approved" distinction for regulatory assets, but observe that the APCO Case cited by the Examiner would not have demanded a different result in this case had a distinction between old and new regulatory assets been applied. We find that no distinction should be made between previously approved and newly created regulatory assets for the purposes of an earnings test. In our view, the principle of cost recovery should not change depending on whether a regulatory asset is newly created or already exists.

Roanoke contends that an earnings test penalizes it for having previously existing regulatory assets on its books. The

Company further suggests that if the bottom of the range is used as the benchmark, Roanoke effectively cannot earn above that point. These arguments are without merit. First, Roanoke's AIF demonstrates that the Company can earn above the top of the range after writing off all of its regulatory assets.⁵

Moreover, the Company is not penalized by the use of the earnings test in conjunction with deferrals. Rather, deferral of costs and creation of regulatory assets have benefited Roanoke. A regulatory asset is a current charge that has been deferred with permission from a regulatory authority to be amortized over future periods. Such costs are generally large and nonrecurring and may cause a utility's financial results to be materially and negatively affected when they are currently expensed. By permitting a regulated public utility to defer costs, the utility is afforded an opportunity to recover these costs over future periods. Shareholders benefit from the original deferral of the charges associated with regulatory assets because the deferral increases earnings above what they would have been had no deferral been allowed and the costs expensed. The earnings test simply measures, period to period, whether deferred expenses have been actually recovered more

⁵ Even after the write-off of all of the Company's regulatory assets present on its books for the twelve months ended March 31, 1996 (the test period for Roanoke's AIF), the Company earned a 12.79% return on equity when its authorized range was 11.2% to 12.2%.

quickly than originally anticipated or whether they should continue to be deferred and amortized. The test is the same used to establish the original amount of the deferral and is fair to both shareholders and ratepayers. If the Company wishes to avoid the earnings test, it need not request and should object to, any proposed deferral of large, nonrecurring expenses.

Based on the foregoing, we find that the Company's regulatory assets, as well as the costs associated with the demolition of the retired gas manufacturing plant, should be written to the bottom of Roanoke's authorized return on equity range, and that the Company requires an increase in gross annual revenues of \$237,634 in order to earn a 9.663% return on rate base, rather than the \$260,432 in gross annual revenues recommended by the Hearing Examiner.

Accordingly, IT IS ORDERED THAT:

(1) The findings and recommendations of the Chief Hearing Examiner's April 30, 1998 Report, as modified and supplemented herein, are accepted.

(2) The Company shall be granted an increase in gross annual revenues of \$237,634, effective for service rendered on and after January 1, 1997.

(3) The Company shall forthwith file revised permanent schedules of rates and charges designed to produce the

additional revenues found reasonable herein, effective for service rendered on and after January 1, 1997. The final increase in revenues shall be distributed on an equal percentage basis to each volumetric rate block within each of Roanoke's rate schedules.

(4) On or before November 30, 1998, Roanoke is directed to recalculate, using the rates being established by this Order, each bill it rendered that used, in whole or in part, the interim rates being replaced by the rates established by this Order. In each instance where application of the rates being established by this Order yields a reduced bill to the customer, the Company is directed to refund with interest as directed below, the difference.

(5) Interest upon the ordered refunds shall be computed from the date payment of each monthly bill was due during the interim period until the date refunds are made, at an average prime rate for each calendar quarter. The applicable average prime rate for each calendar quarter shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin, or in the Federal Reserve's Selected Interest Rates ("Selected Interest Rates") (Statistical Release G.13), for the three months of the preceding calendar quarter.

(6) The interest required to be paid herein shall be compounded quarterly.

(7) The refunds ordered in Paragraph (4) above may be accomplished by credit to the appropriate customer's account for current customers (each refund category shown separately on each customer's bill). Refunds to former customers shall be made by check to the last known address of such customers when the refund amount is \$1 or more. Roanoke may offset the credit or refund to the extent no dispute exists regarding the outstanding balances of its current customers or customers who are no longer on its system. To the extent that outstanding balances of such customers are disputed, no offset shall be permitted for the disputed portion. The Company may retain refunds owed to former customers when such refund amount is less than \$1. However, Roanoke shall prepare and maintain a list detailing each of the former accounts for which refunds are less than \$1, and in the event such former customers contact the Company and request refunds, such refunds shall be made promptly. All unclaimed refunds shall be handled in accordance with § 55-210.6:2 of the Code of Virginia.

(8) On or before January 20, 1999, the Company shall file with the Staff a document showing that all refunds have been lawfully made pursuant to this Order and itemizing the costs of the refund and accounts charged. Such itemization of costs

shall include, inter alia, computer costs, and the personnel hours, associated salaries and costs for verifying and correcting the refunds directed in this Order.

(9) Consistent with Staff's recommendation, Roanoke shall credit the expense accounts originally charged when billing affiliated companies for management services, accounting, and billing rather than recording management fees as revenues.

(10) In accordance with Staff witness Armstrong's recommendations, the Company shall capitalize various items, totaling \$75,527, identified at pages 15-16 of Ex. SCA-12, which have been expensed by Roanoke. The Company shall book a credit to the appropriate operations and maintenance expense accounts in the current period with a debit to the appropriate asset accounts, as agreed to by Company witness Williamson.

(11) Roanoke shall file an earnings test with the Commission if it seeks to establish any new regulatory assets.

(12) Roanoke shall file an earnings test with its next AIF or rate application if the Company has regulatory assets on its books at the time of its filing.

(13) There being nothing further to be done herein, this matter shall be dismissed, and the papers filed herein made a part of the Commission's file for ended causes.